Loreley Fin. (Jersey) No. 3, Ltd. v Morgan Stanley & Co. Inc.
2016 NY Slip Op 32820(U)
July 26, 2016
Supreme Court, New York County
Docket Number: 651633/2014
Judge: Jeffrey K. Oing

SUPREME COURT OF THE STATE OF NEW YORK
NEW YORK COUNTY

PRESENT: JEFFREY K. OING J.S.C.
Justice

PART 48

Index Number : 651633/2014
LORELEY FINANCING (JERSEY)
vs.
MORGAN STANLEY & CO.
SEQUENCE NUMBER : 002
DISMISS

INDEX NO. _____
MOTION DATE _____
MOTION SEQ. NO. _____

The following papers, numbered 1 to _____, were read on this motion to/for _____

Notice of Motion/Order to Show Cause — Affidavits — Exhibits _____ No(s). _____

Answering Affidavits — Exhibits _____ No(s). _____

Replying Affidavits _____ No(s). _____

Upon the foregoing papers, it is ordered that this motion is

Mtn decided in accordance of the accompanying Memorandum decision/order of this Court.

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

Dated: 7/26/16

JEFFREY K. OING, J.S.C.
J.S.C.

1. CHECK ONE: ..... ☐ CASE DISPOSED ☒ NON-FINAL DISPOSITION
2. CHECK AS APPROPRIATE: .....MOTION IS: ☐ GRANTED ☐ DENIED ☐ GRANTED IN PART ☐ OTHER
3. CHECK IF APPROPRIATE: ..... ☐ SETTLE ORDER ☐ SUBMIT ORDER
☐ DO NOT POST ☐ FIDUCIARY APPOINTMENT ☐ REFERENCE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL PART 48
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LORELEY FINANCING (JERSEY) NO. 3, LIMITED, and LORELEY FINANCING (JERSEY) NO. 18, LIMITED

Plaintiffs,

-against-

MORGAN STANLEY & CO. INCORPORATED, MORGAN STANLEY & CO. INTERNATIONAL LIMITED, MORGAN STANLEY CAPITAL SERVICES, INC., COUNTRYWIDE ALTERNATIVE ASSET MANAGEMENT INC., COUNTRYWIDE SECURITIES CORP., ALPHA MEZZ CDO 2007-1, LTD., and BANK OF AMERICA CORP,

Defendants.

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Index No.: 651633/2014

Mtn Seq. Nos. 002 & 003

DECISION AND ORDER

Relief Sought

Mtn Seq. No. 002

Defendants, Morgan Stanley & Co. Inc., Morgan Stanley & Co. International Ltd., and Morgan Stanley Capital Services, Inc. (collectively, "Morgan Stanley") move, pursuant to CPLR 3211(a)(1) and (a)(7) and CPLR 3016(b), for an order dismissing the complaint of plaintiffs Loreley Financing (Jersey) No. 3, Limited, and Loreley Financing (Jersey) No. 18, Limited (collectively, "Loreley").

Mtn Seq. No. 003

Defendants, Countrywide Securities Corp., and Countrywide Alternative Asset Management Inc. (collectively, "Countrywide")

move, pursuant to CPLR 3211(a)(1), (a)(5), and (a)(7), CPLR 3013, and CPLR 3016(b), for an order dismissing the complaint.

These two motions are consolidated for disposition.

Factual Background

This action arises from plaintiffs' investment in Alpha Mezz CDO 2007-1, LTD. ("Alpha Mezz"), a collateralized debt obligation ("CDO") backed by residential mortgage-backed securities ("RMBS") (Compl., ¶ 1). Morgan Stanley and Countrywide structured Alpha Mezz, marketed it to investors, drafted all of the deal-related documents, and acted as the initial purchasers of the notes issued by Alpha Mezz, which they then sold to investors (Compl., ¶ 1, 40).

Morgan Stanley and Countrywide began marketing Alpha Mezz to plaintiffs in early 2006 (Compl., ¶ 49). Over multiple meetings, defendants represented that they had a better understanding of the quality of the RMBS which would be included in Alpha Mezz than ratings agencies, such as Standard & Poor's, because of their exclusive access to an unparalleled database of information (Compl., ¶¶ 56-57, 62, 65, 72-73)

Countrywide and Morgan Stanley knew plaintiffs were interested in investing in the safest, senior tranches of CDOs (Compl., ¶¶ 83-85). Defendants represented to plaintiffs that Alpha Mezz would be structured such that the Class II and III

notes in which plaintiffs would invest would be rated AAA (the rating reserved for the highest quality investments subject to the lowest level of credit risk) and AA (the rating reserved for high quality investments subject to a very low credit risk), respectively (Compl., ¶¶ 83-85).

Plaintiff maintains that despite these assurances Morgan Stanley and Countrywide were aware prior to plaintiffs' investment in Alpha Mezz that many of the underlying mortgages in Alpha Mezz did not satisfy underwriting guidelines and were likely to fail (Compl., ¶ 17). For example, at least $25 million of Alpha Mezz's portfolio was from New Century, a residential loan originator (Compl., ¶ 148). Defendants represented that New Century collateral was of high quality in terms of underwriting compliance and performance (Compl., ¶ 60). In fact, this collateral faced severe risk of deterioration and failure (Compl., ¶ 16). Morgan Stanley was aware of this because they served as the warehouse lender and securitizer of the New Century loans (Compl., ¶¶ 138, 147). Moreover, Morgan Stanley and Countrywide retained Clayton Holdings, Inc. ("Clayton") to perform due diligence on the loans purchased from New Century and were informed that these loans violated underwriting guidelines (Compl., ¶¶ 138, 153).

Prior to the closing of plaintiffs' investment in Alpha Mezz, Morgan Stanley sent plaintiffs' investment advisor a blacklined version of the final offering memorandum (the "Offering Memorandum") on February 27, 2007, which highlighted all changes made to the preliminary offering memorandum after January 22, 2007 (Black-lined Offering Memorandum, Hakki Aff., Ex. F).

In the Offering Memorandum, plaintiffs acknowledged that: (1) neither Countrywide nor Morgan Stanley was "acting as a fiduciary or financial or investment adviser;" (2) plaintiffs were not relying (for purposes of making any investment decision or otherwise) upon any advice, counsel or representations (whether written or oral) of Morgan Stanley or Countrywide other than representations in such final presentation to investors and the Offering Memorandum, and any representations expressly set forth in a written agreement with such party; and (3) plaintiffs had "carefully read the final presentation to investors, dated February 27, 2007, relating to the Notes and the final Offering Memorandum, including, without limitation, the section entitled 'Risk Factors' therein" (Offering Memorandum at pg. 189, Hakki Aff., Ex. G). These "Risk Factors" included a number of disclaimers regarding risks involved in RMBS securities, including, inter alia, that: "In recent months, delinquencies and

losses on residential mortgage loans generally have increased and may continue to increase, particularly in the case of [certain] subprime loans" due to "[a] continued decline or a lack of increase in [nationwide property values]" as well as "fraudulent activities of borrowers, lenders and appraisers" (Offering Memorandum at pg. 37 Hakki Aff., Ex G [emphasis added]). The Offering Memorandum stated that there was no assurance that underwriting procedures and policies and protections against fraud would be sufficient to prevent "significant levels of default or delinquency on mortgage loans" (Offering Memorandum at pg. 38, Hakki Aff., Ex. G).

On February 28, 2007, plaintiffs invested $32 million in Alpha Mezz (Compl., ¶ 15). On April 25, 2008, Alpha Mezz experienced an event of default (Compl., ¶ 161). On July 24, 2008, Alpha Mezz's Class II and III notes were downgraded to CC, or "junk status" (Compl., ¶ 161). On or about June 26, 2009, Alpha Mezz was liquidated, wiping out plaintiffs' $32 million investment (Compl., ¶161).

Procedural History

In October 2012, plaintiffs filed an action against Countrywide and Morgan Stanley relating to plaintiffs' investment in Alpha Mezz (the "2012 Action"). In that action, plaintiffs asserted claims for rescission, fraud, conspiracy to defraud,

aiding and abetting fraud, fraudulent conveyance, and unjust enrichment (Hakki Aff., Ex. A). The 2012 Action was dismissed without prejudice (Hakki Aff., Ex. B).

On May 28, 2014, plaintiff commenced this action asserting claims for: (1) rescission; (2) fraud; (3) fraudulent conveyance; and (4) unjust enrichment. On October 1, 2014, this Court granted defendant's motion to dismiss the complaint as time-barred. On appeal, the First Department reversed (Loreley Financing (Jersey) No. Ltd. v Morgan Stanley & Co. Inc., 133 AD3d 425 [1st Dept 2015]).

Discussion

I. Fraud (second cause of action)

To plead a fraud claim, a plaintiff must allege that: (1) the defendant made a material misrepresentation of fact; (2) the misrepresentation was made intentionally in order to defraud or mislead the plaintiff; (3) plaintiff reasonably relied on the misrepresentation; and (4) plaintiff suffered damage as a result of its reliance on the defendant's misrepresentation (P.T. Bank Cent. Asia v. ABN Amra Bank N.V., 301 AD2d 373, 376 [1st Dept 2003]).

Here, plaintiffs allege that defendants misrepresented the quality of the assets comprising the CDO's collateral pool and the risk of loss for the notes purchased by plaintiffs, that

plaintiffs relied on this information in investing in Alpha Mezz and that they were harmed as a result (Compl., ¶¶ 221-225). Defendants argue that they made no misrepresentations and that any statements about their expertise regarding the quality of the collateral in Alpha Mezz was simply "sales puffery."

Defendants' argument is unavailing. Even in the absence of any affirmative misrepresentation or any fiduciary obligation, however, a party may be liable for nondisclosure where it has special knowledge or information not attainable by plaintiff (Basis Yield Alpha Fund (Master) v Goldman Sachs Group, Inc., 115 AD3d 128, 135 [1st Dept 2014]). Plaintiffs' allegations that defendants, as underwriters of Alpha Mezz, had special knowledge of the degree of risk involved and concealed such risks from plaintiffs is sufficient to state a claim for misrepresentation (Basis Yield Alpha Fund Master v Stanley, 136 AD3d 136, 139-140 [1st Dept 2015]).

Defendants next argue that the disclaimers in the Offering Memorandum preclude any claim of justifiable reliance based on any of defendants' alleged misrepresentation. A "buyer's disclaimer of reliance cannot preclude a claim of justifiable reliance on the seller's misrepresentations or omissions, however, unless: (1) the disclaimer is made sufficiently specific to the particular type of fact misrepresented or undisclosed; and

(2) the alleged misrepresentations or omissions did not concern facts peculiarly within the seller's knowledge" (Basis Yield Alpha Fund (Master) v Goldman Sachs Group, Inc., 115 AD3d 128, 137 [1st Dept 2014]).

Here, the disclaimers were merely general warnings about risks involved in investment in CDOs and failed to inform plaintiffs that the particular RMBS in Alpha Mezz were highly susceptible to these risk despite defendants' alleged knowledge that many of the underlying mortgages did not comply with underwriting guidelines. Such disclaimers of general macroeconomic and structural factors that may affect the performance of a security are insufficient to preclude justifiable reliance (Basis Yield Alpha Fund (Master) v Goldman Sachs Group, Inc., 115 A.D.3d 128, 137-138 [1st Dept 2014] [offering circular's disclosure concerning recent residential mortgage difficulties and statement that change in economic conditions might adversely affect performance and market of RMBS were boilerplate statements regarding risky nature of investing in mortgaged-backed CDOs rather than specific disclaimers]; Basis Yield Alpha Fund Master v Stanley, 136 AD3d 136, 140-141 [1st Dept 2015] [offering materials stating that unrated securities were highly speculative and risky did not negate justifiable reliance claim where defendants understated the overall risk of

the entire CDO structure]; Loreley Fin. (Jersey) No. 3 Ltd. v. Citigroup Global Mkts. Inc., 119 AD3d 136, 140, 143-144 [1st Dept 2014] [offering circular's disclosure that RMBS collateral would be subject to various types of risks, including credit risks, liquidity risks and interest rate risks was insufficiently specific to preclude justifiable reliance because it failed to track particular misrepresentations and omissions alleged by plaintiffs]). In short "the seller's disclaimer regarding the inherently risky nature of mortgage-backed bonds did not encompass the secret risk that the seller had deliberately selected the riskiest assets" (Loreley Fin. (Jersey) No. 3 Ltd. v Citigroup Glob. Markets Inc., 119 AD3d 136, 144 [1st Dept 2014]).

HSH Norbank, on which defendants rely, is inapposite. In that case "the allegations of the amended complaint itself established that [plaintiff] could have uncovered any misrepresentation of the risk of the transaction through the exercise of reasonable due diligence within the means of a financial institution of its size and sophistication" (HSH Nordbank AG v UBS AG, 95 AD3d 185, 188-189 [1st Dept 2012]). Here, unlike HSH Norbank, the allegations do not reveal that plaintiffs were of such financial size and sophistication that an exercise of reasonable due diligence would permit the disclaimers to be a bar to these claims. Indeed, plaintiffs explicitly

allege that knowledge concerning the assets in Alpha Mezz was exclusively in defendants' possession (Compl., ¶¶ 3, 16).

Although this Court initially dismissed the fraud claim in the 2012 Action based on the First Department's ruling in ACA Financial Guaranty Corp. v Goldman, Sachs & Co., 106 AD3d 494, 497 (1st Dept 2013) (6/20/2013 Tr. at pp. 16-17, 19-22, 28, Hakki Aff., Ex. B), the Court of Appeals' reversal of the First Department's holding alters the pleading requirements for fraud under these factual circumstances (25 NY3d 1043 [2015]). Based on the Court of Appeals' decision, and the foregoing analysis, plaintiffs have sufficiently stated a cause of action for fraud.

Accordingly, that branch of defendants' motion to dismiss the fraud claim is denied.

II. Rescission (first cause of action)

Plaintiffs maintain that defendants' representations and omissions with respect to Alpha Mezz were intentionally incomplete, misleading and false when made and seek a judgment rescinding their investment in Alpha Mezz and directing defendants to return the $32 million that plaintiffs paid for the Alpha Mezz notes, with interest (Compl., ¶¶ 210, 217).

A claim for rescission will lie only in the absence of a complete and adequate remedy at law (Loreley Fin. (Jersey) No. 28, Ltd. v. Merrill Lynch, Pierce, Fenner & Smith Inc., 117 AD3d

463, 468 [1st Dept 2014]). Here, as plaintiffs' complaint demonstrates they will be made whole by the award of money damages.

Accordingly, that branch of defendants' motion to dismiss this claim is granted, and the cause of action for rescission is hereby dismissed (Loreley Fin. (Jersey) No. 3 Ltd. v Citigroup Glob. Markets Inc., 119 AD3d 136, 148 [1st Dept 2014])

III. Fraudulent Conveyance (third cause of action)

Plaintiffs allege that Morgan Stanley sold assets to Alpha Mezz for more than these assets were worth thereby rendering Alpha Mezz insolvent and unable to meet its obligations to investors, and argue that the sale was fraudulent under sections 273, 274, and 276 of the Debtor Creditor Law ("DCL"). As such, they contend that transactions should be set aside (Compl., ¶¶ 236-239).

"As a general rule, the relief to which a defrauded creditor is entitled in an action to set aside a fraudulent conveyance is limited to setting aside the conveyance of the property which would have been available to satisfy the judgment had there been no conveyance" (Joslin v Lopez, 309 AD2d 837, 839 [2d Dept 2003]). Plaintiffs are limited-recourse creditors of Alpha Mezz (Offering Memorandum at pp. i, 2, 30, 40, 64, Hakki Aff., Ex. G) and, as such, they have a right only to the collateral assets of

Alpha Mezz (and any revenue generated by those assets) with no claim to the funds Alpha Mezz used to purchase the collateral assets. Under those circumstances, plaintiffs may not invoke the law of fraudulent conveyance here (Loreley Fin. (Jersey) No. 4 Ltd. v UBS Ltd., 123 AD3d 413, 414 [1st Dept 2014] citing Loreley Fin. (Jersey) No. 3 Ltd. v Wells Fargo Sec., LLC, 2013 WL 1294668, at *15 [SDNY Mar. 28, 2013], revd in part, vacated in part, 797 F3d 160 [2d Cir 2015]).

Accordingly, that branch of defendants' motion to dismiss this claim is granted, and the fraudulent conveyance cause of action is dismissed.

IV. Unjust Enrichment (fourth cause of action)

Plaintiffs claim that defendants were unjustly enriched by their investment in Alpha Mezz and seek a judgment ordering defendants to disgorge all amounts they received as a result (Compl., ¶ 241). A claim for unjust enrichment will not lie, however, where the transaction at issue is governed by a written agreement (Loreley Fin. (Jersey) No. 3 Ltd. v Citigroup Glob. Markets Inc., 119 AD3d 136, 148 [1st Dept 2014]). As such an agreement existed here, that branch of defendants' motion to dismiss the unjust enrichment claim is granted, and it is dismissed.

Accordingly, it is

ORDERED that defendants' motions to dismiss the complaint's second cause of action is denied; and it is further

ORDERED that defendants' motions to dismiss the first, third and fourth causes of action is granted, and they are hereby dismissed; and it is further

ORDERED that defendants are directed to serve an answer to the complaint within ten (10) days after service of a copy of this order with notice of entry; and it is further

ORDERED that counsel are directed to appear in Part 48 (Room 242) for a preliminary conference on August 24, 2016 at 11 a.m.

This memorandum opinion constitutes the decision and order of the Court.

Dated: 7/26/16

HON. JEFFREY K. OING, J.S.C.